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Mexico's Toughening Policy Toward Foreign Investment

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MEXICO'S TOUGHENING POLICY TOWARD FOREIGN INVESTMENT

Mexico's new restrictions on foreign direct investment have made the economy less attractive to US businessmen. Outlays by US investors apparently have dropped sharply this year from the recent annual average of some US $130 million. The longer term impact depends both on how the policy is administered and on the investment opportunities available in other countries, many of which are also moving to restrict foreign control over their economies.

Measures that became effective in February and May require that Mexicans have majority ownership and management control in new companies, restrict foreign takeovers of established firms, and aim at reducing parent companies' royalties from their subsidiaries' use of product designs and production processes. According to government spokesmen, the ownership and control requirement will be waived for new investments that bring in advanced technology, create jobs in depressed areas, or are export oriented.

The key question bothering US investors is how strict the government will be in applying the Mexican equity requirement. As in the past, many of them probably will resist entering joint ventures on a minority basis, especially since the new laws weaken their influence over subsidiaries in such cases. Most will seek exemptions from the domestic equity requirement, but initial indications are that the government may be sparing in granting them.

Because competitive pressures on US companies to gain footholds in the Mexican market are strong, some will focus on exports to gain approval of majority US ownership. Over the longer term, increased export orientation of new US-owned plants will tend to have an adverse effect on the US trade balance with Mexico. Lower US capital flows than would be the case in the absence of the new laws, however, will tend to offset this effect to some degree.

Note: Comments and queries regarding this memorandum are welcomed. They may be directed to [redacted] 25X1

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Discussion

Investment Climate and Control

1. Since the 1940s, political stability, responsible monetary and fiscal policies, and import restrictions have fostered rapid expansion of the Mexican economy. Aiding the expansion was a large increase in direct investment, mainly by US companies. During 1961-72, the book value of US investment in Mexico rose by about 150%, to \$2.0 billion.[1] Annual net US outflows (including retained earnings) have averaged some \$130 million in recent years.

2. US investment in Mexico grew despite government restrictions, which rank among the strictest in the Western Hemisphere. Under Mexicanization legislation enacted beginning in 1938, foreign investors have been excluded from petroleum extraction, banking, public utilities, and certain other service activities. In addition, these investors have been restricted to minority ownership in most other extractive industries, agriculture, and certain manufacturing industries. Majority ownership by Mexicans has been encouraged in other fields by tax exemptions and other incentives. US businessmen nevertheless continued to be attracted by those investment opportunities that remained.

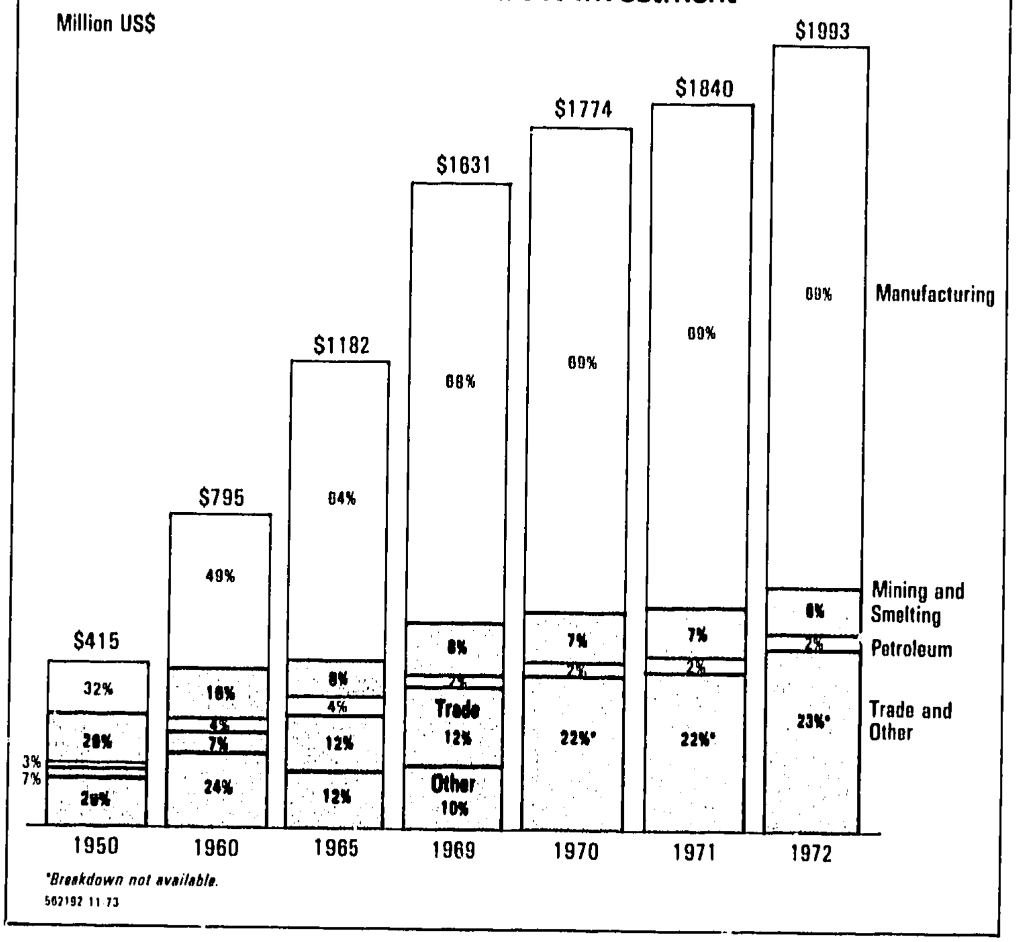
Structure and Impact of Foreign Investment

3. Because of the Mexicanization restrictions, investment in manufacturing rose from one-third of the book value of US holdings in 1950 to more than two-thirds in 1972 (see the Chart). Foreign holdings – mainly US – account for 5%-10% of total manufacturing investment. All automobile assembly and nearly all production of machinery, electrical equipment, and industrial chemicals are in foreign hands. Although greatest in value in automobile assembly and chemicals, US manufacturing investments are distributed among a fairly wide variety of activities (see the Table). About 50% of manufacturing companies with US equity are joint ventures, and about 25% have majority Mexican ownership.

4. The holdings of investors from countries other than the United States account for about 20% of the direct foreign investment. Like those of the United States, most are in manufacturing – by value, predominantly automobile assembly, chemicals, and tobacco and food processing. The United Kingdom and West Germany long have accounted for the largest

1. US investors also have large holdings of portfolio capital in Mexico. At the beginning of 1973, holdings of US banks and other financial institutions amounted to \$1.8 billion, and unrecorded private US holdings also were substantial.

MEXICO: Book Value of US Direct Investment



Mexico: Number of Manufacturing Companies with US Equity, 1970

Total	**630**
Non-electrical machinery	158
Chemical products	104
Food and beverages	49
Electronic products	49
Textile products	40
Metal products	39
Pharmaceuticals	37
Automobile parts	32
Electrical equipment	29
Cosmetics	18
Paper	9
Automobile assembly	4
Other industries	62

shares of the non-US total. Japanese investment -- chiefly in automobile assembly, steel, and salt extraction -- has been the most dynamic in the last year or two, however, and Japan's stake in Mexico is approaching those of the United Kingdom and West Germany.

5. Mexico has benefited substantially from direct foreign investments, which have been accounting for 5%-10% of total annual private investment. Apart from the added capital, the benefits include acquisition of management skills and technology, substantial import savings, and export development. Most foreign manufacturing investments have been of the import-replacement variety. But about 10% of the US funds have gone into the border industries, which mostly process or assemble imported US goods for re-export to the United States. These firms, established since 1965 under exemption from the Mexicanization restrictions and import controls, accounted for about one-half of exports of manufactured goods in 1972.[2]

6. The United States also has benefited from direct investment in Mexico. Although import replacement has cut into the market for some US manufactures, exports of intermediate and capital goods have been stimulated. During 1963-72, for example, US sales of manufactured goods to Mexico increased from $600 million to $1.5 billion. Moreover, the US trade surplus in these goods expanded by 60%, to about $800 million, despite a nearly ninefold rise in US imports of Mexican manufactures. The United States, in addition, has received substantial remittances of profits, management fees, and royalties from US subsidiaries. Such receipts averaged $192 million annually in 1969-71 -- half again as much as the net direct investment outflow to Mexico.

The Government's Hardening Attitude

7. Growing US investment in recent years has increased Mexican fear of US domination. Inspired by these feelings, President Luis Echeverria signaled during the election campaign his intention to be more selective in admitting foreign investment. No major steps were taken, however, during the first year and one-half following his December 1970 inauguration. Instead, he chose to deal with the high inflation rate, the slowdown in economic growth, and the record trade deficit.[3] One motive for his doing so was to convince investors that Mexico still was a safe, profitable place to put their money.

8. Meanwhile, the government's policy on foreign investment did show signs of hardening. Echeverria and other officials said publicly that

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only those investments contributing substantially to exports, technological advance, or employment were welcome. Officials reviewing investment proposals became more critical of those calling for dominant foreign ownership. The statutory requirement for domestic ownership of new companies producing automotive parts was increased from 51% to 60%. The government raised raw tobacco prices following nationalization of several small British-owned raw tobacco marketing companies, putting pressure on US and British processing firms to Mexicanize to qualify for tax rebates. Yielding to growing government pressures, the Anaconda Company sold to the government a controlling interest in its large Cananea copper mining subsidiary – the last mining company remaining wholly in foreign hands.

9. At the same time, the government further encouraged foreign investments promising an advance in the technical level of exports. In December 1971, Chrysler Corporation was asked to increase equity in its Mexican subsidiary to promote production of automotive parts for the US market. While continuing to express reservations publicly about the border industry program, the government extended it to nearly all areas of the country in October 1972.

10. By mid-1972 the administration felt sufficiently in command of the financial situation to initiate broader restrictions on foreign investment. The program was launched with a broadside against foreign influence by Horacio Flores de la Pena, a leftist cabinet member who has become Echeverria's leading economic spokesman. In August 1972, Flores stated, for example, that Mexico "must crush the chains of dependency and of useless colonialist economics." The rhetoric served the dual purpose of dramatizing complicated measures for the public and of preempting the foreign investment issue from leftist political groups.

Investment Control Legislation

11. In September 1972 the administration introduced a law that regulates the terms under which a subsidiary uses the parent firms's technology. The law, which took effect on 1 February 1973, requires government approval of present and future contracts for the acquisition of patent rights, production processes, technical assistance, and the like. To be approved, such contracts must not require payment for obsolete or freely available technology, limit exports or research and development, or stipulate settlement of contract disputes in foreign courts. The law also prohibits contracts that provide "excessive" royalties or management fees or give the US firm control over the subsidiary's operations. When deemed in Mexico's interest, the latter requirements may be waived.

12. The provisions of the technology law obviously will have little effect on parent company control of subsidiaries in which they have majority ownership. Foreign companies in joint ventures with Mexican interests on a minority basis, however, will be adversely affected because reduced control could increase the risks of such ventures. The law also will tend to reduce the profitability of direct foreign investments. Government spokesmen say that approval generally will be limited to contracts providing for royalties of 3% or less of gross sales, in contrast to the commonly charged 5% rate. The government will take the hardest line on contracts in such consumer fields as pharmaceuticals, cosmetics, and processed foods, where it wants to encourage domestic investment. Contracts involving more advanced technology in non-consumer fields will most easily obtain approval.

13. A second law, announced in December 1972 and made operative on 8 May 1973, requires at least 51% Mexican equity in new firms, with certain possible exceptions. It also sharply restricts foreign takeovers of domestically owned firms, requires government approval of increases in the foreign share in established firms to more than 25%, and limits foreign managerial participation in new firms to the proportion of ownership. According to government spokesmen, the majority ownership requirement may be waived for new firms producing primarily for export, bringing in advanced technology, providing employment in depressed regions, or offering other special benefits. Under the law, the government obviously can waive the domestic participation requirements for new firms it deems desirable and enforce them for those it wishes to discourage -- mainly in consumer industries of the import-replacement variety. Taken together, the two laws make Mexican restrictions on direct foreign investment almost as tough as those in force in several of the Andean Pact countries in South America.

Business Reactions

14. Already disturbed by the Echeverria administration's hardening attitude, the foreign and domestic business communities were shaken by announcement of the laws. The announcement caused a temporary capital flight of some $300 million in the fourth quarter of 1972. The flight mainly reflected the transfer of funds abroad by domestic businessmen -- who stand to benefit from the increased Mexicanization requirements -- in the unsubstantiated fear that the announcement signaled a later attack against them. The government subsequently reduced its anti-business rhetoric and tried to reassure foreign investors that the new laws will be administered reasonably.

15. Nevertheless, much uncertainty among foreign investors remains. Because the impact of the laws will depend partly on how administrative bodies interpret them, many foreign businessmen have adopted a wait-and-see attitude. They are particularly concerned as to what types of investment will qualify for waiver of the domestic equity requirements. Many US businessmen fear that the laws will sharply limit opportunities for profitable investment; some suspect that they will be used to restrict US investments while encouraging outlays by the Japanese and others. Although some investments already in progress have been continued, mainly by firms long-established in Mexico, uncertainty has sharply reduced investment applications this year.

Initial Experiences Under the Laws

16. Some 5,000 existing contracts have been approved under the technology law, and apparently only a few have been rejected. The Foreign Investment Commission – charged with administering the second law -- has held only a few meetings. Of the investment proposals reviewed thus far, most have been returned to the applicants for further information or referred to other government agencies for study. The Commission has issued final rulings in only a handful of cases: three or four applications involving majority foreign ownership have been approved, and about the same number have been disapproved.

17. The Commission's first ruling was less harsh than earlier government statements might have suggested. The ruling provided that new investment in established firms need maintain only the previously existing ratio of Mexican to foreign equity. It implied that 100% foreign-owned firms may continue to expand without taking in Mexican shareholders, rather than requiring 51% domestic equity in the expansion. Nevertheless, government spokesmen indicate that such firms will be required to obtain majority Mexican equity in the new investment if they wish to adopt new product lines.

Prospects

18. As the details of the new policy emerge, direct investment inflows should begin to revive from this year's depressed level. The new laws nevertheless seem likely to have a lasting adverse effect on their magnitude. Although some investors will accept minority equity positions, others will not. The latter will refrain from investing unless they can qualify for waiver of the majority Mexican equity requirements. The technology law also will discourage investment, in some instances by making the transfer of technology less profitable.

19. Direct investors in some fields can reasonably expect majority foreign ownership to be approved. Government spokesmen have already indicated that neither law will affect investment in border industries because they are heavily export oriented. Investments in such industries as basic chemicals, machinery, and electrical equipment probably will also be granted waivers because they bring in technology. Profitable investment opportunities in consumer goods industries almost certainly will be reduced. To keep up with competitors in the Mexican market, some US companies may be willing to set up export lines as a means of getting waivers. Few investors can be expected to seek waivers for locating in depressed areas, which generally are remote from principal Mexican markets and lack skilled labor and transport facilities.

20. In time, the new policy could adversely affect the US current account balance with Mexico. Payments of royalties and management fees by US subsidiaries to their parent firms will tend to be lower. Moreover, as the new policy induces foreign investors to increase their export activities, the US trade balance could be adversely affected. With the increase in the export orientation of US subsidiaries, US imports of manufactured goods will tend to rise in relation to US exports of capital and intermediate goods. A partial offset of uncertain magnitude, however, will be provided by the adverse effect of the toughened policy on the outflow of US capital to Mexico.